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UNCLAS SECTION 01 OF 04 KUALA LUMPUR 001629

SIPDIS

STATE PASS USTR - WEISEL, JENSEN AND MAIN
STATE PASS FEDERAL RESERVE AND EXIMBANK
STATE PASS FEDERAL RESERVE SAN FRANCISCO TCURRAN
USDOC FOR 4430/MAC/EAP/J.BAKER
TREASURY FOR OASIA AND IRS

GENEVA FOR USTR

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV MY
SUBJECT: ISLAMIC BANKS CAN'T KEEP UP WITH DEMAND

REF: Kuala Lumpur

¶1. (U) Summary: Local Islamic banks are unable to keep pace with the rapidly increasing demand for Financial Services consistent with Islamic Law (Shariah). According to one local analyst, demand now outpaces supply two to one, and not just among Muslims. The expectation of higher returns is driving the growing demand among Muslims and non-Muslims alike. The GOM, building toward its vision of becoming a global hub for Islamic finance, recently announced a new initiative to promote Islamic banking through tax incentives and government-sponsored scholarships to train experts in Islamic finance. Also, in an effort to attract more business from the Middle East, the Securities Commission of Malaysia signed a memorandum of understanding with the Dubai Financial Services Authority on August 15 to address different interpretations of Shariah and work toward mutual recognition of each other's Islamic financial products. To further boost Malaysia's image as a global Islamic financial center, Bank Negara (Malaysia's Central Bank) will begin to adopt some Islamic policy instruments in its operations. End Summary.

Demand Outpaces Supply

¶2. Malaysia's Islamic banking industry is booming. In 2005 alone, total assets of Islamic banks rose 17.7% to RM 117.4 billion (USD 31.7 billion). Islamic corporate bonds (sukuk) constituted 46% or RM 125 billion (USD 33.8 billion) of total Malaysian corporate bond issuance. In the first half of 2006, 26 new Islamic corporate bonds of RM 23 billion (USD 6.2 billion) were issued, accounting for 71% of Malaysian corporate bond issues. According to the CEO of a major local bank, Islamic corporate bonds offer higher rates of return of between 10-15 basis points over conventional corporate bonds. In Malaysia, more than 50% of such bonds are held by non-Muslims.

¶3. Islamic finance, when undertaken according to the spirit in which it was intended, involves higher risks as it requires an investor to take an equity position, sharing in the profits and losses of the group, with no

guarantees. On average, this higher risk position tends to offer higher returns. Other Islamic financial products abide primarily by the letter of Islamic law, for example, by using service fees in place of interest; these closely mimic conventional products in terms of both risk and return. Whatever the risk, return, and fees, there is a broad perception that Islamic financial products offer a better deal; in fact, one prominent local U.S. businessman reports that salesmen often claim that commercial institutions "rake in huge profits" while Islamic financial service providers charge only a "service fee."

¶4. Citibank's Islamic banking subsidiary in Malaysia recently conducted research to determine whether Malaysian Muslims preferred to do business with an Islamic bank or with a global bank's Islamic subsidiary. (At the time, Citibank was considering whether to enter a joint venture with a local Islamic bank.) The research showed that, on average, younger Malaysian Muslims were concerned primarily with the financial returns, with little regard for Islamic banking principles. Older Malaysian Muslims responded that, as long as the subsidiary was certified as being Shariah-compliant, they preferred "the world-class services of a world-class bank" (as described by one Citibank official) over a local Islamic Bank.

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Going Global: GOM Launches the Malaysian International Islamic Financial Center Initiative
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¶5. At the Malaysian Islamic Finance Forum on August

14, Bank Negara Governor Zeti launched the Malaysia International Islamic Financial Centre (MIFC) initiative that aims to enhance inter-linkages in the global Islamic financial markets and strengthen Malaysia's position as an international Islamic financial hub. The initiative entails three major elements: special tax and regulatory treatment, scholarships, and harmonization of Islamic banking and insurance practices.

Tax and Regulatory Treatment

¶6. Bank Negara will provide tax incentives to qualified foreign and Malaysian financial institutions that establish International Currency Business Units providing a full range of Islamic banking products and services in international currencies. This represents a significant shift from current Malaysian policy, which permits international currency transactions only in Labuan, Malaysia's offshore banking center. The MIFC initiative also will allow qualified foreign and Malaysian insurance companies to provide a full range of Islamic insurance (takaful) products in international currencies. Offshore Islamic banking operations will be allowed greater flexibility to open offices anywhere in Malaysia. Currently, the GOM sets the number of branches foreign banks may establish throughout Malaysia and must approve the location of any new branch. (A recent decision allowed foreign banks to open exactly six additional branches - neither less than nor more than six. There is much speculation that this also will be liberalized.) In addition, Islamic banks will be exempt from GOM restrictions on the employment of expatriates to top positions.

¶7. There is some speculation among Islamic bankers that the GOM's 2007 budget, to be released on September 1, will extend incentives and tax breaks to Islamic

Real Estate Investment Trusts (REITs) and to Islamic banks outside of the Labuan offshore banking center. Currently, a holding company established in Labuan is not required to pay any taxes and its offshore trading companies can choose a flat corporate tax of RM 20,000 (USD 5500) or a 3% tax on revenue. (Outside of the Labuan offshore financial center, the corporate tax rate is 28%.) In comparison, Dubai and Bahrain impose no taxes on Islamic financial products, and Singapore, a newcomer in the Islamic banking industry, offers a very liberal tax regime across the board for the Islamic banking products. One Islamic Banking executive pointed out that Malaysia needs to match what others are offering to attract more funds, particularly from high net worth individuals from the Middle East. He also pointed out the need for tax breaks designed to help the industry recruit and retain talent.

Scholarships

¶8. There is broad recognition that one of the main constraints on the industry is a shortage of financial executives well-versed in Shariah, and a shortage of Shariah scholars well-versed in finance. Language is yet another barrier. Few Malaysian financial executives are fluent in Arabic, and few Shariah scholars are fluent in English. Fluency in both areas of expertise -- and in both languages -- will be essential to reach the global Islamic financial market. The GOM plans to expand its scholarships to develop the human resources to meet this need.

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Addressing Differences in Shariah Interpretations
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¶9. Addressing the August 14 forum, Bank Negara Deputy Governor Mohammed Razif Abdul Kadir said Malaysia may be strong in Islamic finance at the domestic level, but

needs to strategize to elevate to the next stage of growth in the global arena. As there are differences in the Shariah interpretations and practices between Malaysian and Middle Eastern nations, Razif said the MIFC would advocate mutual recognition and accommodate the various juristic reasoning based on contemporary analysis and logical inference, so long as it is recognized by the Shariah advisers. Razif said Bank Negara was ready to take the lead in the harmonization of Shariah interpretations, and in fact has begun to convene strategic dialogues among scholars within the region and globally. However, he said that diversity in Shariah interpretation must be allowed in order to support product innovation and meet the needs of the industry.

Dubai and Malaysia Seal Deal

¶10. On August 15, the Dubai Financial Services Authority (DFSA) and the Securities Commission (SC) of Malaysia signed a memorandum of understanding (MOU) to facilitate Islamic financial transactions between the Dubai International Financial Centre (DIFC) and Malaysia. The Securities Commission of Malaysia reports that the MOU will facilitate inter-jurisdictional cooperation on enforcement; strengthen channels for information exchange, cooperation and consultation; and promote development and training initiatives. It also will seek to promote cross-border transactions and work to streamline regulatory standards between the two countries. Securities

Commission Chairman Zarinah Anwar told Embassy Economic Specialist that the DIFC was well-positioned as a gateway to the vast growth potential of the Middle East in Islamic finance.

Central Bank to begin adopting
Islamic Banking Practices

¶11. Zeti also announced that Bank Negara soon would incorporate the Islamic practice of "murabahah" into its policy instruments to manage short-term liquidity in the Malaysian Islamic inter-bank money market. Murabahah is the "cost plus" approach, whereby a product is sold at a pre-agreed price that includes a profit margin. The profit margin serves to compensate the bank for its services, but provides no penalty for late payment. Bank Negara's murabahah based-transactions likely will utilize global or Malaysian commodities for the underlying transaction. Zeti also announced that Bank Negara planned to add other Shariah-approved policy instruments, including Islamic bonds based on the sale and lease concept ("Ijarah sukuk"). The Malaysian Islamic financial market already has introduced a variety of Islamic financial hedging instruments, including the Islamic profit rate swap, the Islamic cross-currency swap and the Islamic forward rate agreement. Malaysia also has established Shariah-based unit trusts which have demonstrated a compound annual growth rate of 59% from 1992-2005 with a net asset value of RM 8.6 billion (USD 2.3 billion). These are expected to grow rapidly.

Comment

¶12. With the government's avid support, the Malaysian Islamic banking industry is set to continue its path of rapid expansion. The booming demand for Islamic financial services is not necessarily an indication that Malaysian Muslims are becoming increasingly religious. Rather, the perception -- and sometimes the reality -- of greater returns is driving demand in Malaysia. Demand-driven and government-accelerated, Islamic finance -- with its broad array of new financial products and services -- represents

significant growth potential for the Malaysia's financial sector. The biggest hurdle to Malaysia's success in becoming a global hub for Islamic finance may be the Government's own heavy handed regulation of the finance industry, which it micromanages while at the same time striving to promote. Conventional financial institutions in Malaysia frequently complain that Bank Negara's restrictions prevent them from adopting innovative approaches that would expand their business. If the central bank pursues a similar approach to Islamic finance, institutions in this sector may also find themselves falling behind their foreign counterparts.

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